Diamond Age Russia Fund

Monthly Letter to Investors – May 2013

[Announcement for Diamond Age clients affected by Cyprus: we are advising our clients on their asset recovery from the affected banks in Cyprus, and are accepting enquiries about joining the Diamond Age Cyprus Recovery pool, which will be launched for the international litigation and recovery effort. Please see the attached PDF file ("Cyprus_the_Supreme_Court…pdf") and call us or write to us today for a timely accommodation in the pool and with an indication of your intentions.]

In May, the all-Russia RTS Index sold off another -3.67%, on the back of the overall continued emerging market and commodity weakness, amplified by the Russia and CIS-related storm caused by the unlawful expropriation of investor assets in Cyprus. As the Investment Advisor reported in previous months, although the Fund never had any bank accounts in Cyprus, the entire Russian and CIS equity market, along with the countries in the MSCI EME Index, significantly de-rated in March, April and May, thus bringing the RTS Index to a -12.81% loss year-to-date, after a strong start in January.

International Business Partners and Terms

Investment Advisor	*Diamond Age Capital Advisors Ltd.*
Administrator	*CIBC Bank and Trust Co. (Cayman) Ltd.*
Russian Custodian	*Citigroup – ZAO Citibank (Russia)*
Auditors	*Deloitte – Cayman Islands*
Tax Consultants	*Ernst & Young – Russia and Cyprus*
Legal Counsel	*Campbells – Cayman Islands*
Base Currency	*US Dollar*
Advisory Fee	*2% per annum*
Performance Fee	*20% of profits above hurdle rate*
Hurdle Rate	*US Dollar 3-month LIBOR + 50 bps*
Inception Date	*18 February 2005 at US$100 per share*
Dealing Day	*Friday*
Subscriptions	*Weekly*
Redemptions	*Monthly, 14-day notice*
Min. Subscription	*US$100,000*
ISIN	*KYG2863P1090*
CUSIP	*G2863P 10 9*
Bloomberg Ticker	*DIAMRUS KY <Equity> <Go>*

Historical Performance

	2005	2006	2007	2008	2009	2010	2011	2012	2013
Jan	-	13.67%	1.29%	-10.44%	-11.34%	-0.79%	0.50%	20.43%	12.19%
Feb	2.24%	2.73%	5.70%	2.75%	-11.37%	0.03%	-3.09%	2.83%	-4.34%
Mar	-0.27%	4.05%	-0.29%	-3.48%	20.53%	11.16%	1.30%	-3.75%	-13.84%
Apr	-2.54%	8.80%	1.88%	3.03%	20.86%	1.02%	2.42%	-3.62%	-3.98%
May	-0.51%	-3.78%	-0.71%	9.17%	18.71%	-21.49%	-13.14%	-21.98%	**-2.35%**
Jun	1.84%	-1.67%	2.88%	-7.02%	-3.28%	-2.00%	-4.88%	0.42%	
Jul	7.77%	0.37%	1.75%	-13.09%	3.37%	7.72%	6.17%	0.38%	
Aug	8.76%	2.33%	-4.69%	-8.69%	1.93%	-4.96%	-26.65%	-2.52%	
Sep	12.64%	0.01%	5.07%	-10.76%	18.41%	12.14%	-30.60%	2.13%	
Oct	-6.56%	3.70%	4.99%	-35.75%	10.24%	6.31%	22.32%	-1.85%	
Nov	7.49%	5.36%	-2.96%	n/a	3.66%	-0.13%	-22.84%	-1.76%	
Dec	7.33%	9.49%	0.80%	n/a	8.34%	16.66%	4.55%	9.38%	
Year	**43.27%**	**53.70%**	**16.26%**	**-57.73%**	**103.00%**	**21.92%**	**-55.48%**	**-5.12%**	**-13.30%**

NAV Data, Current Asset Allocation

Fund Price (W/Avg), Main Class	**Bid $97.65; Offer $98.07**
Designated Investment Share Class	**$65.57**
Total Fund Assets (AUM)	**$10,973,364**
Total Firm AUM	**$219,096,619**

Long	**110.1%**
Short	**0.0%**
Gross	**110.1%**
Net	**110.1%**
Leverage	**10.1%**

DIAMOND AGE
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But although the Fund was indirectly but significantly affected by Cyprus, in May it nevertheless outperformed the main Russian index by 132 basis points, losing only -2.35%, while the RTS fell by -3.67%.

As the Investment Advisor argued in his March and April Letters to Investors, every crisis, including the mini-crisis in Cyprus, presents an opportunity. There is now a chance to pick up some very cheap good quality stocks for the longer term. Additionally, in the Fund's opinion, the current EM valuation in general, and the Russia valuation in particular, present an excellent entry point for a long-biased value play with a 3 to 5 year investment horizon. For a more detailed analysis of the current rock-bottom valuation metrics, please refer to the April Letter to Investors at the following link:

Sector Allocation	
Financials	21.87%
Metals and Mining	20.90%
Gas Utilities	5.91%
Media	5.90%
Agriculture	5.54%
Conglomerate	5.45%
Consumer Durables	4.60%
Oil - Integrated	4.49%
Industrials	4.38%
Fisheries	4.25%
Construction/Infrastructure	4.04%
Telecoms	3.84%
Retail	3.34%
Chemicals	3.28%
Electrical Utilities	2.21%
Total	**100%**

http://www.diamondage.ru/newsletter/Eng_DA_Apr_13.pdf

Why has the whole EM space de-rated, and Russia even more so, since late summer of 2011? Well, one point of view, published by a respected Russia strategist, is that the commodity supercycle is over, after "conveniently" ending in autumn of 2011, with the benefit of hindsight. *"The end of rapid investment-led growth in China and the typical supply and demand responses to high prices have led many to conclude that the commodity supercycle is over, implying a stronger dollar and weak performance from commodity markets."* The strategy piece then goes on to predict that oil will edge down 5% per annum, with the Russian market drifting further downwards. In an off-the-record conversation the argument goes something like this: "you see, the market has already de-rated within the last 18 months", implying that this view is "correct".

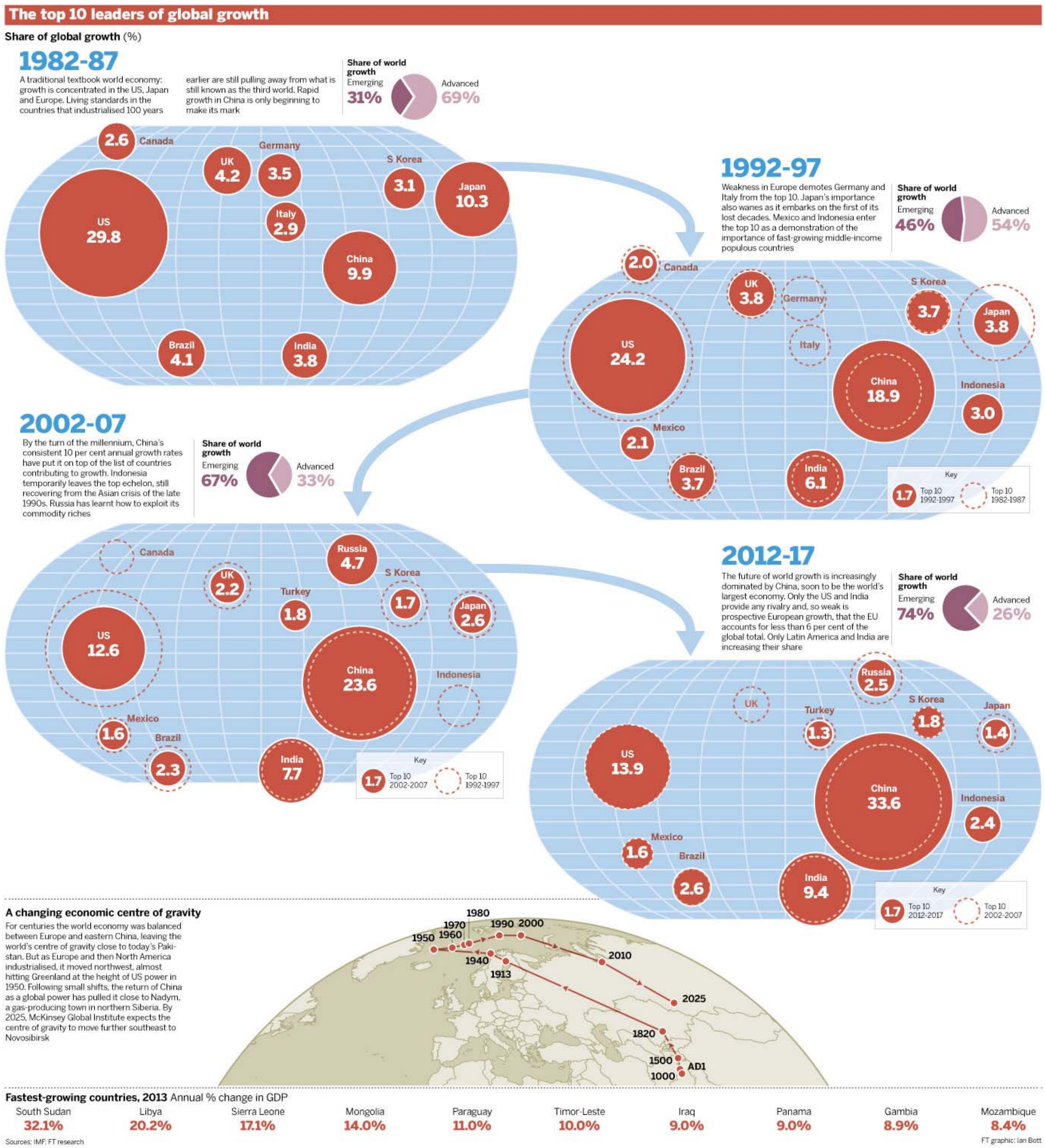
Geographic Dispersion	
Russia	62.08%
Ukraine	10.69%
South Korea	7.88%
Thailand	4.25%
Turkey	4.04%
Kazakhstan	3.98%
Europe	2.73%
Singapore	2.24%
China	1.43%
Guinea	0.68%
Total	**100%**

No, of course the last 18-month de-rating, no doubt, took Diamond Age by surprise… namely, the velocity of the downward spiral combined with a whipsawing volatility, which makes trading the portfolio around extremely difficult. While being 8% over its pre-crisis high-watermark by April of 2011 (which virtually no other regional competitor managed to approach even remotely), the Fund has since lost a lot of its profits, but at these valuations looks into the future with a strong sense of further gains for its long-biased portfolio. Albeit having taken that pain, the Investment Advisor is confident that the afore-mentioned strategist (greatly respected by Diamond Age) is more likely to be wrong than correct.

As the Financial Times recently argued, this year is pivotal for the global economy. Referring to research by the International Monetary Fund and the McKinsey Global Institute, the FT points out that in 2013, for the first time since mechanisation led Britain down the path of industrialization in the 19th century, emerging economies will produce the majority of the world's goods and services:

"The inhabitants of rich, advanced economies have long represented only a small but powerful proportion of the world's population. Now, they are less economically important than the mass of people living in the world's poor and middle-income countries.

The shift in the balance of global economic power is profound. It is also one that economists expect to continue. By 2018, the IMF reckons emerging markets' share of world output will have risen to 55 per cent, making the term "emerging" increasingly irrelevant." This graphic in the FT makes the trends clear:



"Although living standards remain more than five times higher in advanced economies, the gap has been narrowing rapidly since 1990. Where income and growth once went hand in hand, catch-up is now the theme. In addition to the emerging economies' half share of global output, three-quarters of the world's economic growth is set to depend on their dynamism during the next five years.

Jim O'Neill, the recently retired chief economist at Goldman Sachs, likes to use a stark comparison for the shift. Annual growth of 8 per cent in China, he says, is now as important as 4 per cent growth in the US. It is quite a contrast from 1980 when China was growing even faster but was a relative minnow. In 1980, 10 per cent growth in China was less important than 1 per cent of any US expansion.

The long march to prominence of economies outside the Group of Seven – the US, Japan, Germany, the UK, France, Italy and Canada – should come as little surprise. Growth has been stronger in emerging economies for more than 30 years. Per capita living standards have been catching up for the past 20.

This outperformance becomes more striking when mapped out over a long timeframe. Indeed, McKinsey Global Institute has pinpointed the shifting center of gravity of the world economy. In 1950, it lay north of Iceland in the middle of the north Atlantic. Then, as Japan began to take off, it pulled further away from the US and headed east. It is now moving rapidly southeast, shifting more in the past decade than in any other. By 2025, it will sit close to Novosibirsk in southwestern Siberia.

Richard Dobbs, a director of McKinsey Global Institute, says: "China's economic urbanisation and transformation is happening at 100 times the scale of the UK, the first country to urbanize and industrialize and around 10 times the speed... and so China's industrial revolution has 1,000 times the momentum of the UK's industrial revolution".

The shift in global economic dynamism has gone through distinct phases during the past 30 years. In the mid-1980s, large advanced economies still dominated global growth. The US accounted for almost a third, the EU for almost 20 per cent and six of the G7 were in the top 10 countries with the largest contribution to world growth (only France missed out). If the US sneezed, as the cliché went, the rest of the world economy would catch a cold.

The figures were calculated using IMF data and were based on the dollar purchasing power of local currencies, so an equivalent rise in the quantity of goods and services produced in different economies had the same weight.

By the mid-1990s, the former global titans were already dropping out of the big league. Germany and Italy no longer made the grade to be among the top 10 locations for growth, and Japan's importance more than halved. Mexico and Indonesia made the list, a sign that being a growing country with a large population was a sure-fire way to rise in the league.

In the years before the 2008-09 crisis, China emerged as by far the largest source of growth and stormed up the charts to fourth on the back of soaring commodities output and prices.

Britain had been hanging on in the top 10 having enjoyed 30 years of catch-up growth itself after recovering from being the sick man of Europe, but it appears set to drop out of the premier league between 2012 and 2017. The world's top 10 countries by share of global growth will have shifted entirely out of Europe and the whole EU is expected to account for only 5.7 per cent of world growth. Together, India and China will represent almost half of global economic expansion."

Such is the shift of economic power, says the FT, that any company (and Diamond Age says that any investor) still concentrating its portfolio in established economies, really is living in the past.

So how would Russia specifically benefit from the age of emerging markets, and how would its assets re-rate? First and foremost, as has been said here in this forum more than once already…

http://www.diamondage.ru/newsletter/Eng_DA_Feb_12.pdf

http://www.diamondage.ru/newsletter/Eng_DA_Apr_13.pdf

http://www.forbes.ru/investitsii-column/tsennye-bumagi/79658-kontrakt-s-oppozitsiei-ili-kak-putin-mog-zastavit-rasti-fond

…Russia needs further radical reform. The country is ready to move forward, but for its current leadership it has been one step forward, two steps back, for quite a number of years now. The Investment Advisor looked on in horror, having talked about the investment climate in Russia just a month before in its April Letter to Investors, as the very next month, in May, one of the most prominent Russian economists – Sergei Guriev – was squeezed out of the country in a most scandalous way, not heard of since Yukos was dismantled in 2003. And yet – on a turn of a dime – Alexei Navalny announced his candidacy for the September elections of the Moscow mayor, with Sergei Guriev stating, at the same time, that he will be writing an economic program for Moscow's development, for Mr. Navalny's electoral bid, and writing it… out of Paris!

What happened? Radical reform can and will happen in Russia, and the market re-rating will be even more radical… when the time comes. You have to stay the course. Can it be that Mr. Navalny will become the President of Russia and Sergei Guriev will be a reform-pushing historic Prime Minister, turning Russia into a real Eurasian tiger? Anything can happen. Just recollect the last few years of Leonid Brezhnev's rule, and what happened next…

Don't be discouraged and fall into depression by the next two articles. They are true – that's why the current investment climate in Russia is so awful, coupled with the current rock-bottom valuation of assets. The most recent news about Alexei Navalny and Sergei Guriev and their Moscow mayor election bid shows, however, that the regime can indeed change and it will change, as the Investment Advisor argued in its Russian Forbes article, a link to which is provided above. And it doesn't have to be a collapse of the "Putin's regime" and an installation of the "Navalny regime", especially with the Investment Advisor's strong disagreement with some of Mr. Navalny's views, including those on the subject of minorities in such a multi-national and multi-cultural state as Russia. It is all about checks and balances, and about strong reformist economic development and financial block of the government, which can be formed under President Putin and under Moscow Mayor Navalny – with Alexei Kudrin as Prime Minister and Sergei Guriev as the "Economic Czar". How can one beat that power structure?

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http://www.themoscowtimes.com/blogs/476655/post/goldman-sachs-mission-impossible/476656.html

The Moscow Times

Goldman Sachs' Mission Impossible

March 7th, 2013

By Ian Pryde

In the third quarter of 2012, the economy chalked up its 55th straight quarter of growth and surprised analysts on the upside by growing 7.1 percent. The economy has apparently stabilized at 5 to 6 percent per annum recently, but the Finance Ministry reckons that the growth rate could eventually rise to 7 to 8 percent. Although no new taxes have been introduced, the tax take is up by nearly 2 percent of GDP, with the ministry expecting to pull in another 2 to 3 percent. Exports are holding up well despite the global headwinds thanks to the country's diversified economy.

Foreign investors are suddenly very bullish, so portfolio investment is flooding in and international manufacturers are looking to set up production plants.

This happy state of affairs shows how easily a determined president can turn things around.

Since taking office in May 2010, Benigno "Noynoy" Aquino of the Philippines has been vigorously pushing the rule of law and fighting tax evasion and corruption — even former President Gloria Macapagal Arroyo is on trial for electoral fraud.

Seen against this background, the three-year agreement announced in early February that Russia's Economic Development Ministry and the Russian Direct Investment Fund had hired investment bank Goldman Sachs is rather odd.

Goldman is to help set up meetings with investors, better communicate government decisions and advise Russia on its bid to attract more capital and transform Moscow into an international financial center.

But Russia has been advised countless times in the past how to achieve these ends — including since 2000. It simply has to clean up its act by slashing corruption and bureaucracy and changing its policies to both welcome and protect domestic and international investors. Deep down, Russia knows this anyway. Early on in his first term, for example, President Vladimir Putin himself said that from now on there would be a dictatorship of the law, but Transparency International's 2012 corruption perception index ranked Russia 133 out of 176 countries and territories.

Many international and domestic observers, however, argue that the status quo actually suits Putin since the now overweening bureaucracy keeps both business and society at large in check. This chimes in with the president's view of the need for stability after what he and many Russians see as the chaotic 1990s, a view arguably strengthened after the Arab Spring and Russia's own protests last year.

But corruption and bureaucracy deter investors. The Russian business press regularly asks why — despite Russia's low corporate and income taxes — foreigners should invest in Russia when domestic capital flight is so high and Russian companies prefer to list their companies in London, New and Hong Kong rather than Moscow?

Many Russian businessmen simply do not trust the state for historical reasons — the legacy of centuries of arbitrary rule by the czars and the Soviets and the uncertainties since the 1990s. Even now, they say, “We don’t know what’ll happen tomorrow.” Far better to put the money offshore than leave it exposed to the reaches of an unpredictable state.

All too often Russia gives the impression that it is doing investors a favor by allowing them in at all, when it should be vice versa. Even so, in 2012, Putin told the government to increase Russia's ranking in the World Bank's Doing Business rating to 20th by 2018, but although Russia had climbed eight positions to 112 by the Bank's October 2012 review and was above Brazil and India, this is still far too low.

Official Russia still seems reluctant to change its policies and believes the problem lies with its communications, image and an anti-Russian bias abroad. Earlier this year, Deputy Economic Development Minister Sergei Belyakov told reporters, “We don't know how to communicate with investors.” Andrei Kostin, chairman of VTB Group, Russia’s second-largest bank, said last year that Russia was undervalued “because of its image of corruption and lack of necessity to comply with law.”

The problem, however, is not one of image and communication but of Russian reality. The West has tremendous admiration for Russia's art, literature, music and sporting achievements, but has been criticizing the country's corruption and bureaucracy for centuries. And yet, Russia generally refuses to listen to constructive criticism and often reacts in a defensive-aggressive manner to well-meant advice. Goldman may have taken on “Mission Impossible.”

In his recent book “The Strongman: Vladimir Putin and the Struggle for Russia,” which has also appeared in Russian translation, former BBC correspondent Angus Roxburgh gives an account of the Kremlin's amateur approach to PR — something PR insiders knew very well at the time. In the runup to the G8 summit in St. Petersburg in July 2006, the Kremlin hired U.S. PR outfit Ketchum and its European partner GPlus in Brussels and Berlin — neither of which had any Russia experts at all. GPlus therefore approached Roxburgh to be their point man with the Kremlin — although as Roxburgh concedes, he had no PR experience whatsoever. He nevertheless took up the offer and commuted between Europe and Moscow, instead of staying permanently in the Russian capital to do the job properly.

Roxburgh also describes the desultory results of his efforts to help the Kremlin and various ministries with PR. His correct advice on introducing new investor-friendly policies and how the Kremlin could build trusting relations with international journalists was simply ignored.

Moscow also seems to believe that issues such as Sergei Magnitsky’s posthumous trial and the ban against Americans adopting Russian children are totally separate from the country’s investment climate and points out that many international investors and companies operate in Russia and make good profits.

This is perfectly true, but to those who do not know Russia from the inside, the country's ability to make global headlines for all the wrong reasons is always likely to drown out any improvements to its investment climate.

The hope must be that things will be different this time round and that Goldman will have much more success, even though as an investment bank it lacks genuine PR expertise and has suffered reputation loss itself in recent years. This, however, depends on Russia, not on Goldman.

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The Financial Times

Guriev’s flight

Putin’s legitimacy is undermined by crackdown on liberals

May 30th, 2013

Editorial

Vladimir Putin can no longer claim to be maintaining even the appearance of democratic government as he conducts a campaign of intimidation against dissenting voices. The flight of Sergei Guriev, a talented economist and government adviser, after apparent pressure, shows not even the liberal establishment is safe from hardliners around Russia’s president, who are now in the ascendant.

Mr. Guriev, rector of Moscow’s esteemed New Economic School, has fled to France after being questioned about testimony he gave two years ago supporting Mikhail Khodorkovsky, the jailed oil tycoon and Putin critic. Though Mr. Guriev has also voiced support for another opponent of Mr. Putin, the anti-corruption campaigner Alexei Navalny, he has always been an establishment insider. He is close to Prime Minister Dmitry Medvedev, has been a director of state-owned Sberbank and advised on government economic councils.

In the past, such liberal voices have been tolerated on the basis that at least a semblance of democracy had to be maintained if stability was to be guaranteed. But that tolerance has evaporated in the wake of the anti-government demonstrations ahead of Mr. Putin’s re-election last year. The regime is defending its hold on power, using tactics from harassment to politically motivated prosecutions.

The campaign of fear is working. The December 2011 protest movement has withered away. Mr. Navalny, who wants to run for president in 2018 and is the one figure capable of uniting the opposition, is facing flimsy charges of theft and is likely to be convicted – as are most of the regime’s critics.

Yet there is a cost to Mr. Putin’s politics. Since his election, his approval ratings have fallen dramatically, and polls indicate he is bleeding support among Russia’s educated, young and urban voters, mainly in Moscow and St Petersburg. He has been forced to rely on older and rural supporters.

More importantly, capital is quitting the country, the economy is running out of steam and investors hesitate to risk their money in an uncertain political climate. Intimidation may have encouraged protesters to stay indoors but Mr. Guriev's departure suggests that it might also accelerate a flight of Russia's brightest human capital.

The president can choose to ignore the consequences of his chosen path – but they are likely to be grave. Ultimately, his legitimacy depends upon delivering continued growth. Chasing out Russia's brightest will make it almost impossible to achieve that goal.